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# Post-election economic challenges: Scotland and the UK

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1 July 2015

# Outline

## 1. Capacity utilisation

- Any room to spare?
- Can things only get better?
- Scope for SG policy?

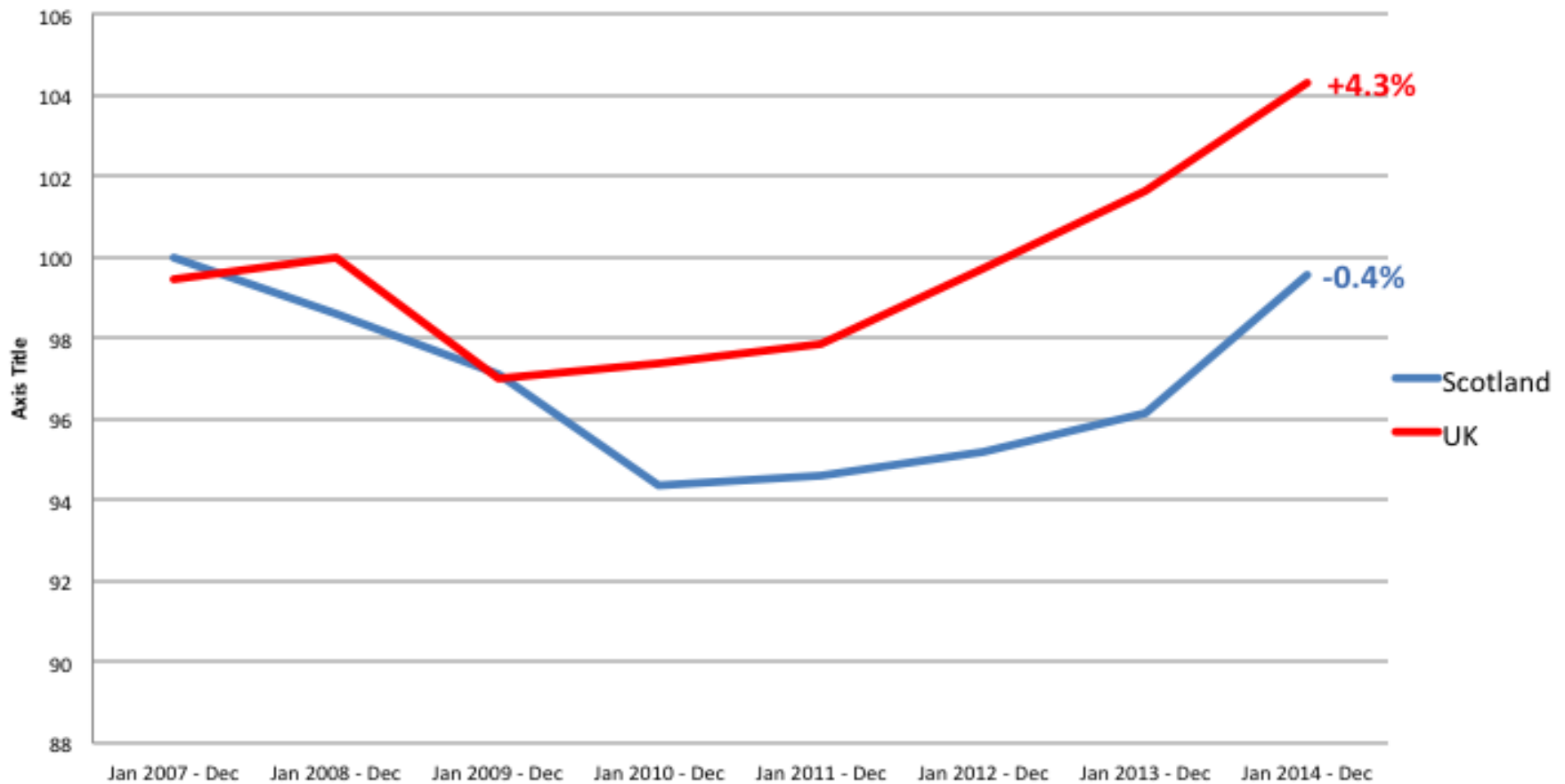
## 2. Capacity growth

- How are we doing?
- Is there an FFA growth challenge?
- What to do about productivity?
- The right strategy?
- Can we get inclusive growth?

# 1. Capacity utilisation

*Any room to spare?*

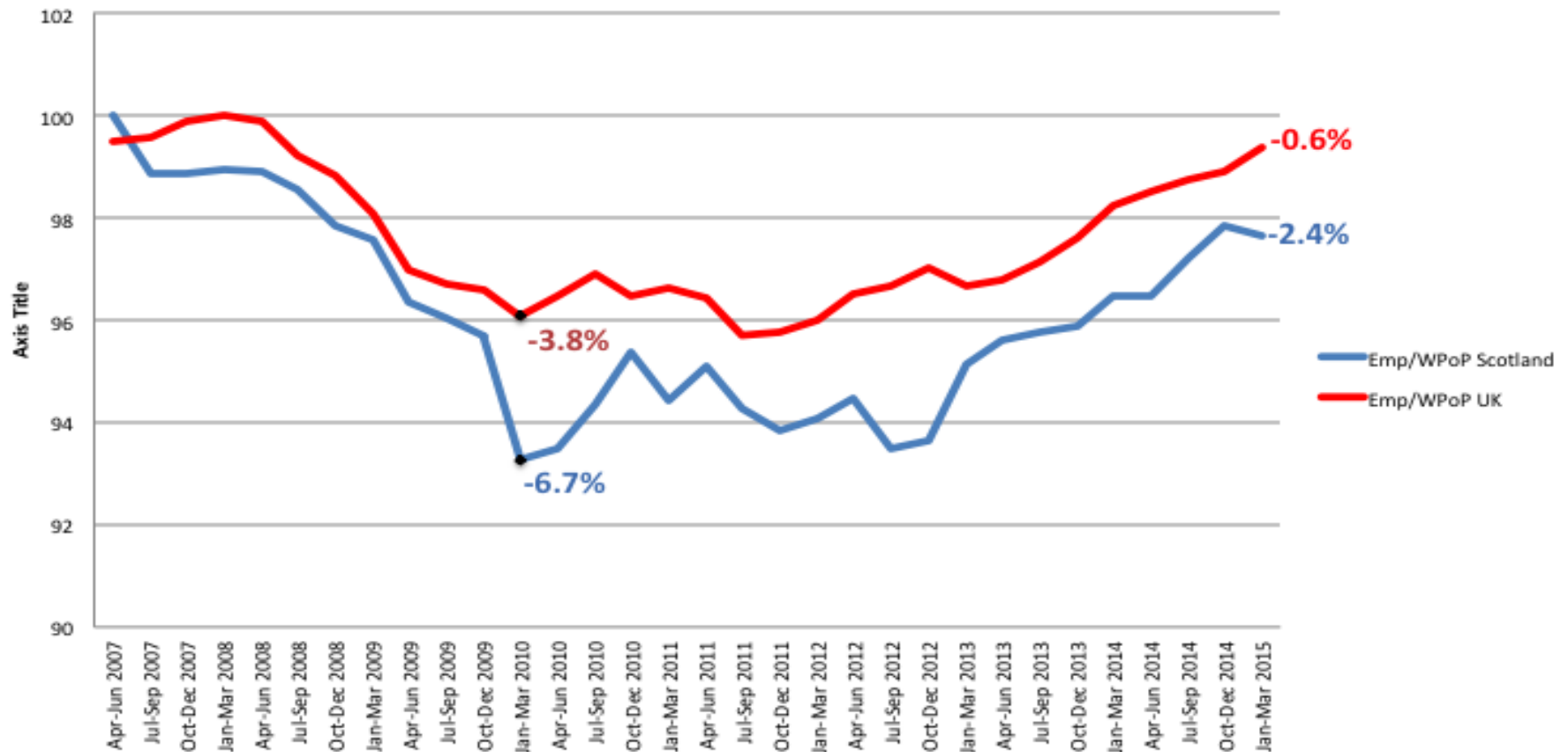
LFS Total weekly hours worked: Scotland-UK in recession & recovery  
(Compared to Pre-recession peak)



# Capacity utilisation

## Any room to spare?

Employment to population (16 & over) Scotland-UK in recession & recovery  
(Compared to Pre-recession peak)



# ***Capacity utilisation***

## ***Any room to spare?***

- Our conclusion on capacity utilisation is that despite the recovery the Scottish economy still has spare capacity available:
  - the number of total weekly hours worked in Scotland is close to but still below the pre-recession peak.
  - the ratio of employment to working population stood at - 2.4% below the pre-recession peak.
  - On both indicators the position is better in the UK
- So the answer is, yes there is room to spare!

# ***Capacity utilisation***

## ***Can things only get better?***

### *The positives:*

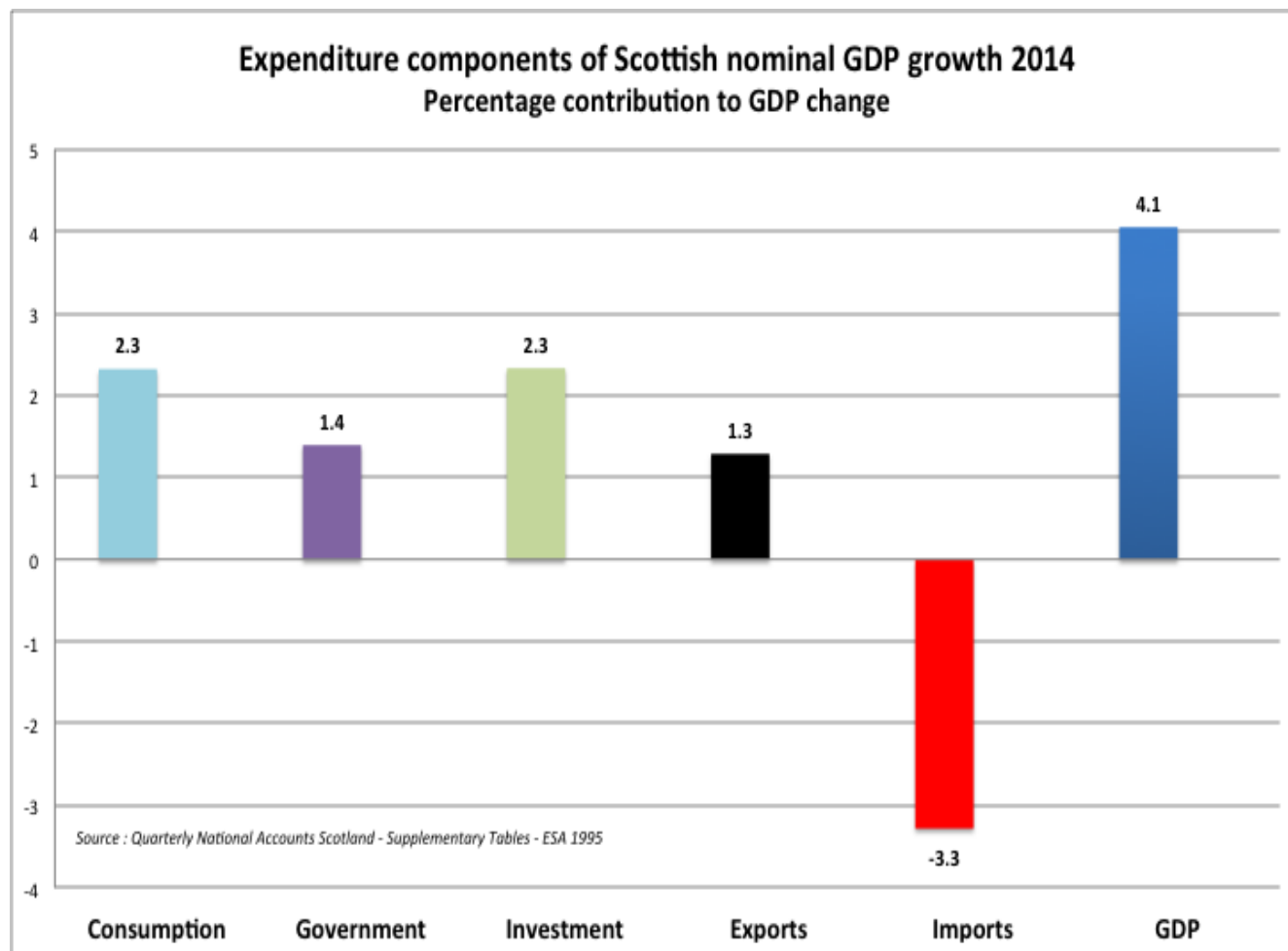
- domestic demand is still growing strongly boosted by investment;
- domestic inflation is close to zero, below nominal earnings/income growth and so boosting real income;
- external demand remains reasonably strong, with growth in the euro area beginning to strengthen while US growth having faltered earlier in the year looks set to pick up again.

# Capacity utilisation

## Can things only get better?

### *The negatives:*

- Growth remains unbalanced with household spending the key driver fuelled largely by rising household debt, which we fear may soon become unsustainable.
- Investment is picking up especially in structures.
- Net trade strongly negative





# ***Capacity utilisation***

## ***Can things only get better?***

### *The negatives:*

- the victory of the Conservatives with a small majority in the May UK General Election appears likely to lead to a continuation and perhaps a tightening of the previous Conservative / Liberal Democrat Coalition austerity plans.
- the growing threat of a Greek exit from the euro with the risk of contagion to other economies including Scotland.

# ***Capacity utilisation***

***Can things only get better?***

*So our answer is:*

- Mibbes aye, mibbes naw!

# ***Capacity utilisation***

## ***Scope for SG policy?***

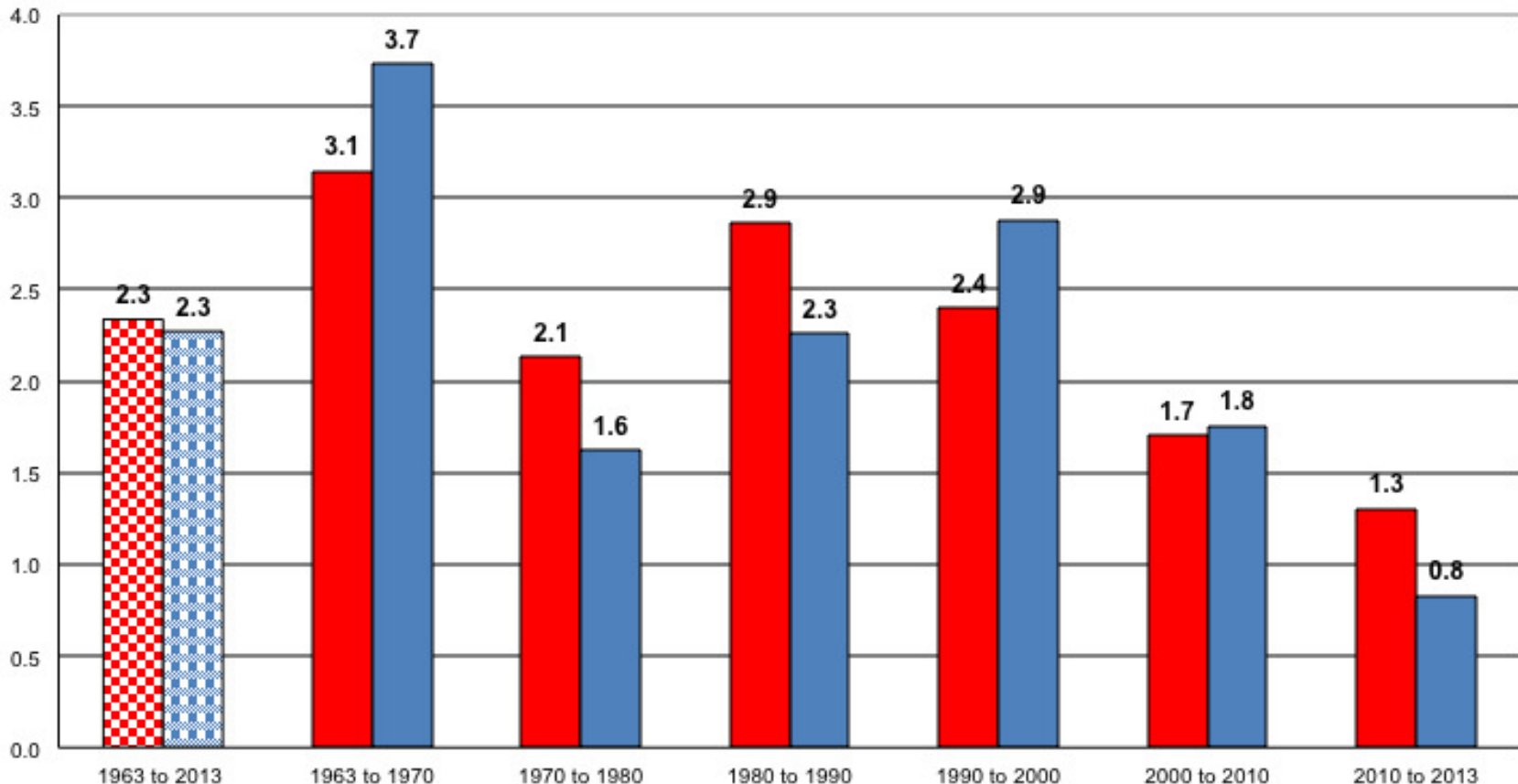
- Scope for Scottish Government to influence capacity utilisation is limited due to:
  - Scottish economy highly open to the UK
    - 70% of its exports
    - Strong corporate / ownership links
    - Labour market links via wage transmission and migration
  - Limited fiscal policy powers, but increasing; yet scope to alter composition of spend to maximise multiplier effects.
  - Part of UK monetary union, so no independent monetary policy.
  - Slightly bigger public sector may act as stabiliser in face of private sector volatility: the flatter Scottish cycle

## 2. Capacity Growth

# Capacity Growth

*How are we doing?*

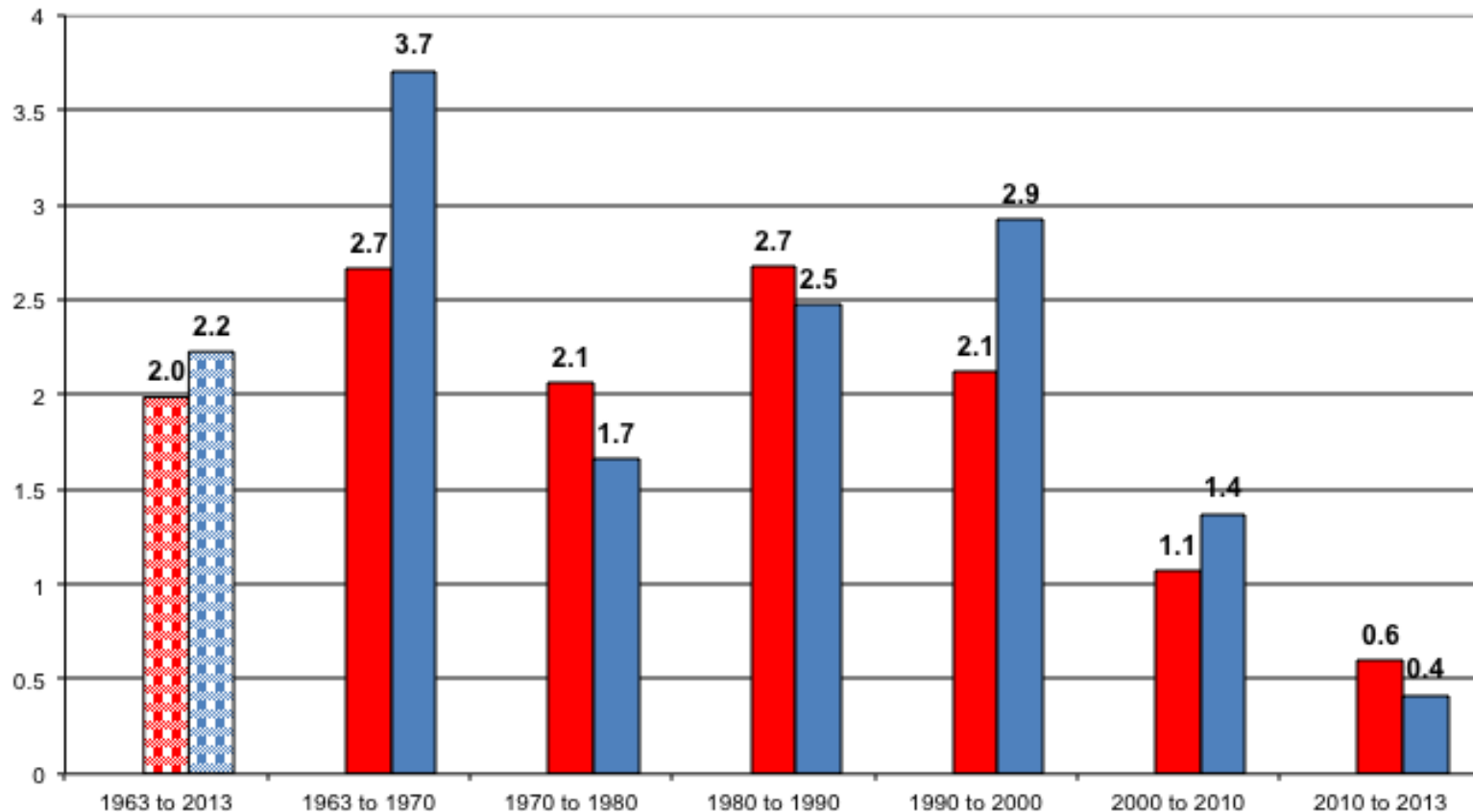
**UK and Scottish GVA Growth 1963 - 2013**  
Percent per annum



# Capacity Growth

*How are we doing?*

**UK** and **Scottish** GVA per head growth 1963 - 2013,  
Percent per annum



# Capacity Growth

## How are we doing?

So, our answer is: not too badly, thank you very much!

- Scottish 'trend' GDP growth over last 50 years is near-identical to UK growth at 2.3% p.a.
- Scottish 'trend' GDP per head growth over last 50 years is 2.2% p.a. faster than UK's 2% p.a. (due to falling or slower population growth in Scotland)
- Interesting to see stronger Scottish growth in 1990s and 2000's, latter in part due to weaker recession here.
- A little worrying that the recovery since 2010 is weaker in Scotland on both measures – no room for complacency!
- *Data health warning*: data compiled under ESA 1995: outturn likely to be different under the new ESA 2010

# ***Capacity Growth***

## ***Is there an FFA growth challenge?***

The answer is, yes! Here's why:

- Scottish 'trend' GDP growth over last 50 years is 2.3% p.a.
- Latest GERS puts government spending (TME) at 44% of GDP and total revenues, incl. geog. share of North Sea oil, are 36% of GDP.
- To stabilise debt-to-GDP would require growth 6.5% p.a. on very favourable real interest rate assumptions of -1.5% and a real rate of zero pushes required growth up to 8% p.a. and so on as real rate rises.
- But assuming here that spending and tax shares of GDP remain constant.



# ***Capacity Growth***

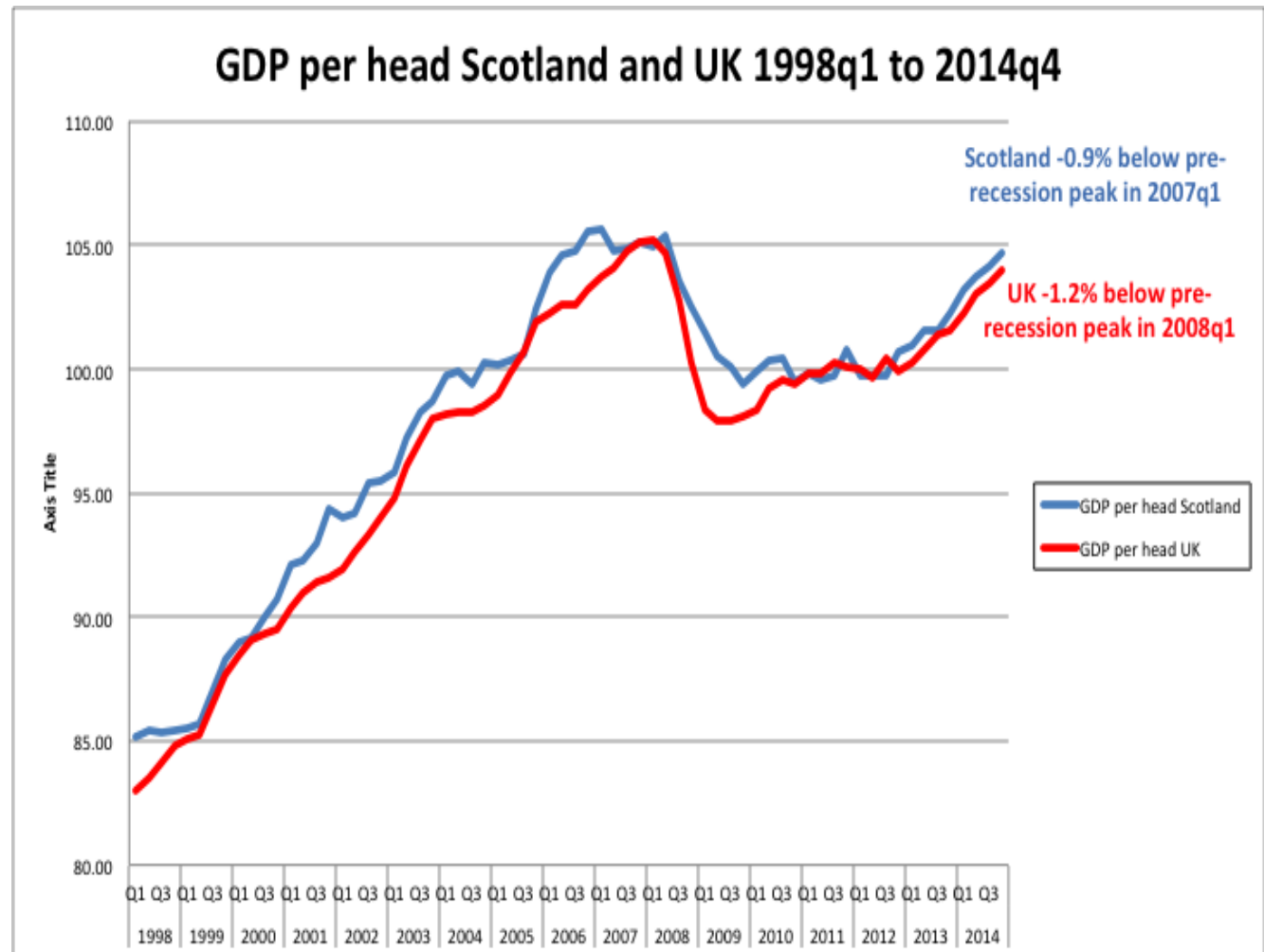
## ***Is there an FFA growth challenge?***

- Clearly, if spending ratio falls – or remains same – and tax ratio rises as growth increases, then lower growth is necessary to stabilise debt/GDP ratio. But still a big ask.
- Even faster growth would be necessary to lower debt ratio, stop the rise in the deficit, and faster growth still to lower absolute deficit.
- Also deficit needs to be funded at likely higher nominal interest rates than UK rates, raising necessary growth rate.
- Can't get away from the fact that FFA will require an increase in the tax burden and lower spending ratio.
- Argument that faster growth can secure a policy of FFA without higher tax and lower spending burdens is a 'red herring'. (in my opinion!)

# Capacity Growth

## *What to do about productivity?*

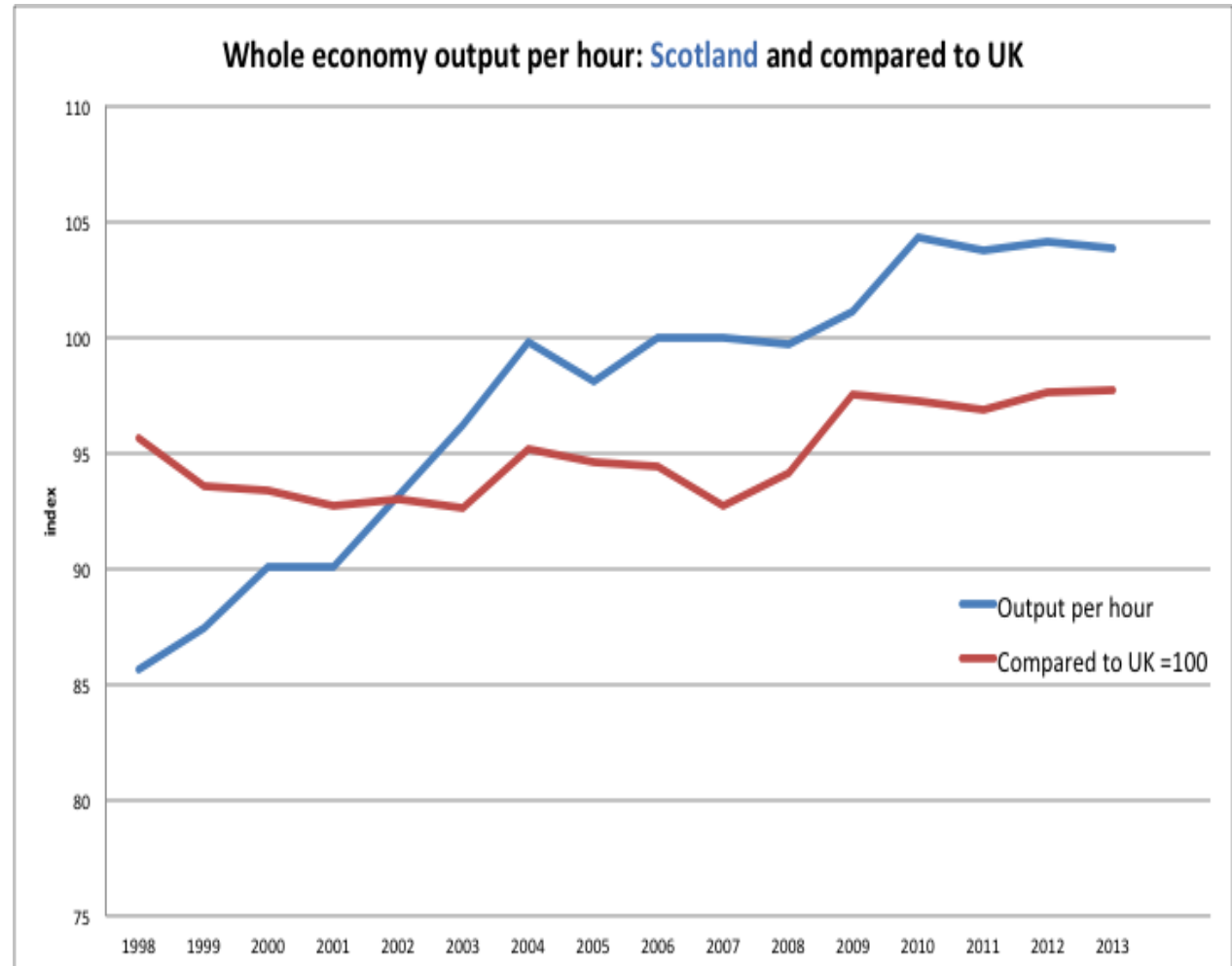
- Once capacity is utilised productivity growth is key to GDP growth.
- GDP per head is closer to pre-recession peak in Scotland than UK.
- Although, recovery slower here, recession weaker and more jobs shed here.
- Hence, economy-wide 'productivity' has held up slightly better in Scotland.



# Capacity Growth

## *What to do about productivity?*

- Chart shows latest (June 24<sup>th</sup>) output per hour data from Scottish Govt.
- Labour productivity has risen absolutely in Scotland by 21% b/w 1998 & 2013.
- Despite this growth it fell behind the UK which grew faster.
- Scotland's relative productivity improved during and after the recession.



# ***Capacity Growth***

## ***What to do about productivity?***

- So Scottish labour productivity while growing, has been weaker than in the UK.
- Moreover, there is research evidence (Richard Harris) that Total Factor Productivity – productivity of all factors: labour, capital and land – is also lower in Scotland than UK.
- Why should this be?
- Consensus (e.g. UK Treasury's 5 productivity drivers) is that we get stronger productivity growth via improvements in:
  - Innovation/R&D
  - Skills
  - Competition
  - Investment
  - Enterprise

# *Capacity Growth*

## *What to do about productivity?*

- The World Economic Forum / many academics rank innovation/R&D and business sophistication as key drivers of productivity.
- In Scotland:
  - **Very low business R&D** (0.6% of GDP, 3.2% of UK BERD) and weak innovation – a critical factor in the theory. But issues around definition and nature of innovation are crucial to policy.
  - **Weak entrepreneurship** (GEM 2009: Scotland's rate of total early stage entrepreneurial activity, among lowest in 20 developed countries)
  - **Below average new firm formation:** VAT registration data show a slight upward trend since the trough of the recession in 2009 and a trend rise in the Scottish share of UK VAT registrations since 2004, which peaked in 2010 at 6.60% but has fallen since to 6.45% in 2012. The historic problem with the business birthrate in Scotland is still evident since we are still adrift of a population share of 8.3%.

# Capacity Growth

## *The right strategy?*

- The Scottish government's latest economic strategy seeks to improve competitiveness (ie productivity performance) and tackle inequality. Its four priorities are shown below :



# ***Capacity Growth***

## ***The right strategy?***



- On the competitiveness front the Strategy is well grounded in theory and practice.
- Much of what the Strategy discusses is exciting and imaginative.
- Yet, in my view, it is weak in two areas:
  - it lacks an organising theme or principle, specific to Scotland.
  - it is not very specific on the 'how', or the implementation, tending to fall back on a plea for more powers.
- Much of the issues addressed in the Strategy could apply to any economy big or small.
- Scotland is a small to middling economy that is very open to trade, investment and migration, particularly with the rest of UK.

# Capacity Growth

## *The right strategy?*

- In small, open economies the rules of economic development are not the same.
- For example, in large economies it is reasonable for policy to focus on domestic productivity to raise growth.
- But in an economy that is significantly open to trade and resource inflows and outflows, particularly inward investment, productivity change may often be the *result* of growth rather than its *cause* e.g. inward FDI raises GDP but since FDI activities are high productivity, average productivity also increases.
- In my view, it's the openness of the Scottish economy that should form the organising principle of Scotland's growth strategy.



# ***Capacity Growth***

## ***The right strategy?***

- Internationalising the Scottish economy so that it links better to, and capitalises on, economic growth in global hubs should be the overarching priority of the Strategy.
- In addition, it also needs to be acknowledged that issues of scale and place probably matter more in small, open economies.
- Well known that economies of scale and agglomeration facilitate growth. Growth is concentrated in space and cities particularly are important in generating lower unit costs and higher productivity via facilitating people attraction and interaction, the creation of diversity and the generation of spillovers.
- The risk is that in smaller economies, by allowing growth to be spread, they may lose economies of scale and hence lose competitiveness unless policy intervenes.

# ***Capacity Growth***

## ***The right strategy?***

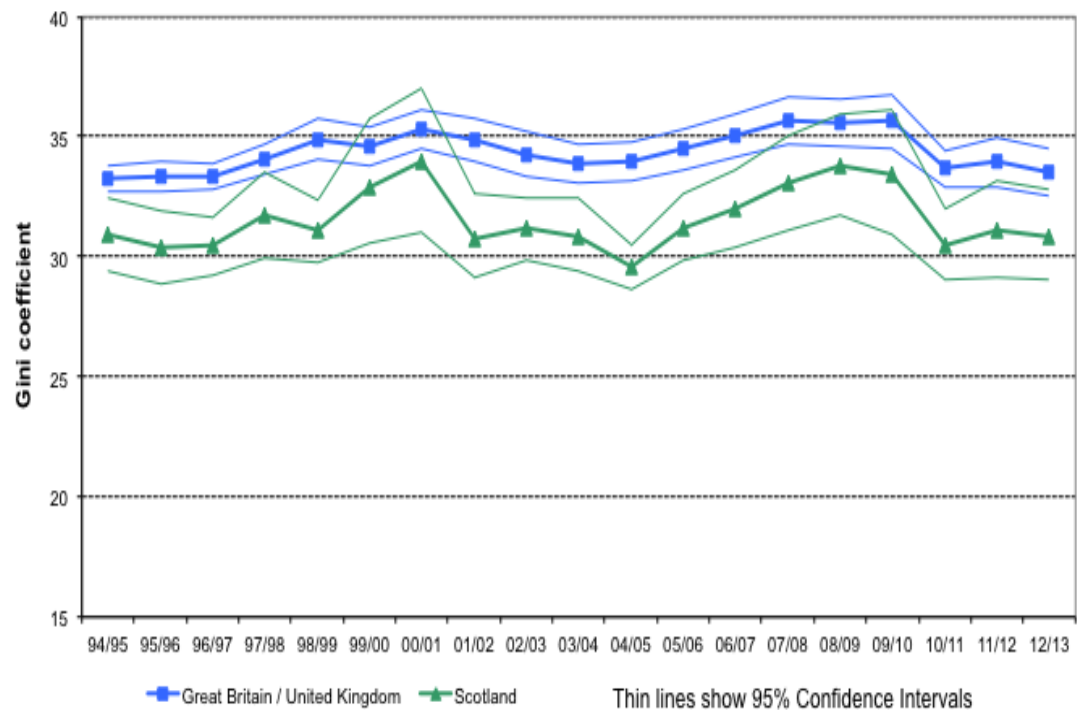
- Classic example of this is the threat posed to Scotland by the UK government's 'Northern Powerhouse' policy, which seeks to boost economic growth in the North of England through stimulating investment in the "Core Cities" of Liverpool, Manchester, Leeds, and Sheffield.
- So, the challenge for Scotland is to build an export base which is more vibrant and diversified than at present; a base that exploits Scotland's openness through attracting inward investment, skilled migrants, knowledge and skills via technology transfer; that builds on the growth advantages of cities; and, encourages R&D & innovation with the purpose of developing capabilities and hence the competitiveness of Scotland's business base.

# Capacity Growth

## Can we get inclusive growth?

- The SG Economic Strategy puts great stress on securing growth that is inclusive.
- Evidence of the importance of an economy's social capital to sustained growth: its institutions, the degree of trust and the degree of inequality.
- The UK and Scotland have a high degree of income (and wealth) inequality (even after tax & benefits - see chart);
- Scotland would rank 20<sup>th</sup> of 34 OECD countries with UK ranked 29<sup>th</sup> in terms of degree of inequality.

Equality of household income as measured by the Gini coefficient, Great Britain / United Kingdom and Scotland 1994/95 - 2012/13 (Smaller figures signify greater equality)



Figures are for the United Kingdom from 2002/03 onwards. Earlier years are for Great Britain only

# Capacity Growth

## Can we get inclusive growth?

- But as the SG's recent *Quarterly Income Inequality Briefing - March 2015* notes:  
“Income inequality can be reduced through redistribution (via tax and benefit changes), but changes in market incomes (total income before any tax or benefits) have a greater impact on inequality.”
- As John Hills makes clear in his brilliant recent book *Good Times Bad Times* the inequality of market pre-tax/benefit incomes in the UK and, with qualifications presumably Scotland, is extreme.
- In 2010 of 31 countries, only in Ireland and Chile was inequality pre-distribution worse than UK.
- However, when the difference between market incomes and disposable incomes is compared only 11 of the 31 countries were doing more than UK to redistribute income.
- The moral of this it seems to me is that, while we can – and in my view should - do more through the tax and benefits system in Scotland and UK to effect more distribution, there is a bigger challenge.
- The big challenge for policy is how to tackle the extreme inequality in market incomes: the massive ratio of CEO pay to median company pay; the role of private versus public education; zero hours contracts; failure to pay minimum wage etc.

# Conclusions

- I've suggested that the post-election economic challenges facing Scotland and the UK can be divided into issues concerning 'capacity utilization' and 'capacity growth'.
- Our conclusion on capacity utilisation is that despite the recovery, the Scottish economy still has spare capacity.
- There are positives helping to sustain the recovery:
  - domestic inflation remains close to zero and, combined with even modest earnings/income growth, is helping to boost real incomes;
  - external demand remains reasonably strong, with growth in the Eurozone beginning to strengthen, and
  - US growth, which faltered earlier in the year looks set to pick up again.

# Conclusions

- But there are also threats to the recovery:
  - a combination of unbalanced growth that relies unduly on household spending that depends mainly on rising and potentially unsustainable personal debt;
  - the UK's overall weak trade performance;
  - the UK Government continuing, or even tightening, planned austerity measures in the forthcoming Budget on 8 July; and
  - the growing threat of a Greek exit from the euro with the risk of contagion to other economies including Scotland.
- The recovery should sustain but outturn remains highly uncertain.
- Scope for Scottish Government to influence capacity utilisation is limited largely because of the openness of the Scottish economy, part of UK monetary union, and limited fiscal powers.

# Conclusions

- Scotland's (capacity) growth performance has been equal to the UK over the last 50 years averaging 2.3% p.a.
- GDP per head has grown faster here over that period 2.2% p.a. compared to 2% in UK.
- The recovery of Scottish GDP since 2010 is weaker than UK and suggests that there is no room for complacency.
- I've suggested that the view that faster growth can secure a policy of FFA without higher tax and lower spending burdens is almost certainly misconceived.
- Productivity is a key driver of growth and is weaker in Scotland compared to UK where it is also weak.

# Conclusions

- Scotland's Total Factor Productivity is probably also lower than UK.
- This may be due to low business R&D, low innovation, weak entrepreneurship, and especially a low new firm formation rate.
- The Scottish Government's economic strategy for the promotion of competitiveness and growth is well grounded in theory and practice.
- but ... it lacks a specific organising theme or principle specific to Scotland's needs and appears weak on implementation.
- In my view it is the openness of the Scottish economy that should form the organising principle of Scotland's growth strategy: to build an export base that links better to global growth hubs and that recognises the key role of cities in growth.



# Conclusions

- The Scottish Government Economic Strategy puts great stress on securing growth that is inclusive.
- In view of the evidence that the distribution of market incomes is extremely unequal in the UK and probably Scotland, while we need do more through the tax and benefits system to effect a more equal income distribution, the big(ger) challenge for policy is how to tackle *directly* the extreme inequality in market incomes.